Public Service Commission of Wisconsin
Direct Testimony of Christopher W. Larson
Gas and Energy Division

Wisconsin Energy Corporation
Docket 9400-YO-100

January 14, 2015

Q. Please state your name, business address, and occupation.

A. My name is Christopher W. Larson. My business address is Public Service Commission of Wisconsin (Commission), 610 N. Whitney Way, P.O. Box 7854, Madison, Wisconsin 53707-7854. I am employed as a Public Utility Auditor – Principal in the Gas and Energy Division.

Q. Would you please state your educational background and summarize your duties with the Commission?

A. I am a 1983 graduate of the University of Wisconsin-La Crosse with a Bachelor of Science degree with a major in accounting. I have been employed with the Commission since 1984. During my employment with the Commission, I have worked on a variety of rate cases and other projects involving telecommunications, electric, natural gas, water, and sewer utilities.

Q. Please explain the purpose of your testimony.

A. My testimony will focus on options for ensuring that customers of Wisconsin Electric Power Company (WEPCO),[1] Wisconsin Gas (WG), and Wisconsin Public Service Corporation (WPSC) (collectively, Wisconsin Operating Companies) share in the financial benefits of synergy savings. I will also comment on ratepayer protection associated with push-down accounting.

[1] In addition to its electric operations, the customers of WEPCO include those of the WEPCO gas operations (WEGO), its Valley Steam (VA Steam) operation, and it Milwaukee County Steam (MC Steam) operation.

SYNERGY SAVINGS

Q. What comments do you have regarding synergy savings?

A. There are various options for ensuring that ratepayers of the Wisconsin Operating Companies receive benefits of synergy savings. Absent the conditions I identify, there is no guarantee that the savings will accrue to ratepayers of the Wisconsin Operating Companies in the first year after the acquisition. As testified to by Commission staff witness Lois Hubert, the Commission is obliged to determine that the acquisition is in the best interest of the utility consumers, investors, and the public. The conditions that I identify may help enable the Commission to determine that the merger meets the best interest of ratepayers.

Q. What conditions have commissions of other states imposed on acquisitions and mergers to ensure that ratepayers receive the benefits of synergy savings?

A. As detailed in Commission staff witness Kevin O'Donnell's testimony, the conditions imposed by other commissions to ensure that ratepayers receive the benefit of some or all synergy savings include:

- Bill credits – ratepayers receive a set amount or percentage applied as a credit on their bills at the time of or shortly after acquisition or merger consummation.
- Social credits – such as additional money spent on energy conservation or renewables.
- Write offs – a portion of deferred costs or net investment rate base is eliminated from the utility's books of account.
- Rate freeze – rates are frozen for a specified period.

Q. What amount of first year synergy savings have customers received in the form of bill credits or social credits as a result of merger/acquisition conditions imposed by other commissions?

A. As described in Mr. O'Donnell's testimony, the average of such credits in other states is equivalent to 2 to 4 percent of non-fuel operation and maintenance (O&M) expense. Mr. O'Donnell also testifies as to the amount that this would represent for each of the Wisconsin Operating Companies.

Q. What is the best way to ensure that ratepayers receive benefits of the acquisition during the first year?

A. My answer varies for each company or relevant service type. For WG, WEGO, VA Steam, and MC Steam, I believe that bill credits are the most appropriate method to ensure that customers receive the benefits of some or all synergy savings. I believe that as a condition of Commission approval of the acquisition, the Commission could consider requiring WG, WEGO, VA Steam, and MC Steam to provide bill credits to all ratepayers either at the time of or shortly after merger consummation. The Commission has already set rates for 2015 as well as 2016 for these companies in docket 5-UR-107. Absent such a condition, customers of these companies would not see any benefit from the acquisition until at least 2017.

Q. If the Commission were to require bill credits for these companies, how would you suggest that they be implemented?

A. As noted in testimony of Commission staff witness Jodee Bartels, it is likely that synergy savings will be realized in the areas of regulated and corporate staffing, corporate and administrative programs, information technology, supply change, gas supply, fuel procurement, generation dispatch, and system control. It would stand to reason that a bill credit should approximate the way in which synergy savings would affect these cost areas, and correspondingly, how those savings would flow to individual customers through the cost-of-service study (COSS) and cost allocation process used in base rate cases. Using 2015 test-year COSS and rate information filed by utility witnesses Robert Jacobson, Eric Rogers, and William Korducki in docket 5-UR-107, I calculated per-customer bill credits at both the 2 percent and 4 percent credit levels discussed above. The calculation of these credits can be found in Ex.-PSC-Larson-2. First year bill credits could be implemented either through a one-time credit or through monthly credits over 12 billing periods.

Q. What condition might be more appropriate to ensure that customers of WEPCO receive the benefits of some or all synergy savings?

A. For WEPCO, bill credits are not the best method, due to its existing balances of deferred costs. The Commission could consider requiring WEPCO, as a condition of Commission approval of the acquisition, to write off part or all of its deferred costs. Like WG and WEGO, WEPCO's rates have been set through the end of 2016. Unlike those companies, however, as explained in direct testimony of Commission staff witness Mary Kettle, WEPCO has a very large balance of deferred costs that has built up over a number of years. As of the end of 2016, WEPCO will have a total deferral balance of slightly over a half a billion dollars, broken down as follows:

Table 1: WEPCO Deferred Cost Balances Projected at 12/31/16 ($ Millions)

	Earning weighted cost of capital	Earning short term debt rate	Total
Deferred transmission costs	$114	$239	$353
Other deferred costs	87	63	150
Total	$ 201	$ 302	$503

Q. Mr. O'Donnell's testimony shows that a range of first year ratepayer credits of 2 to 4 percent of WEPCO's non-fuel O&M equals $24.8 to $49.7 million. Are there any reasons that the Commission might want to require WEPCO to write off a higher amount of regulatory assets than that?

A. Yes, a write-off of regulatory assets in excess of $49.7 million, as discussed further by Ms. Kettle, may be justified for the following reasons:

- Mr. O'Donnell's calculation of the 2 to 4 percent first year ratepayer credits required by other state commissions excludes operating expense write-offs and rate base write-offs that are similar to the write-off of deferred costs I identified. If those other states' write-offs were included in Mr. O'Donnell's calculation, the range of first year ratepayer credits would be higher than 2 to 4 percent.
- As explained in Ms. Kettle's testimony, WEPCO's earned return on equity (ROE) has exceeded its authorized ROE over the period that the deferrals have been building up.
- Mr. O'Donnell's testimony shows that WEPCO's authorized ROE exceeds the national average.

Q. What condition may be more appropriate to ensure that customers of WPSC receive the benefits of some or all synergy savings?

A. For WPSC, bill credits are not the best method because its most recent rate case only set rates through 2015. First year synergy savings could be passed on to WPSC customers through a limited rate case reopener for both the electric and gas utilities the 2016 test year. The filing of this reopener could be a condition of the acquisition. I propose that the items to be included in such a limited reopener be limited to:

- ReACT;
- Monitored fuel costs;
- System Support Resources (SSR) payments;
- Major power plant outage expenses; and
- Synergy savings.

Q. Why do you propose that ReACT costs be reflected in a 2016 test-year limited reopener?

A. The ReACT project is extremely large. In docket 6690-CE-197, the Commission authorized WPSC to construct, install, and place in operation a new multi-pollutant control technology known as ReACT™ at Weston Unit 3. This project is estimated to go into service in April 2016, at an estimated cost of $345 million. Using WPSC's weighted cost of capital and composite depreciation rate, a rough estimate of the 2016 revenue requirement impact of this project is $35 million.[2] This represents an impact of approximately 3.5 percent for this project alone, clearly a substantial impact.

Q. Why do you propose that monitored fuel costs be reflected in a 2016 test year limited reopener?

A. Wisconsin Admin. Code ch. PSC 116 requires that monitored fuel costs be updated each year.

Q. Why do you propose that SSR costs be reflected in a 2016 test-year limited reopener?

A. The SSR payments are potentially large and hard to predict at this point. SSR costs result when a generation resource owner (GRO) wishes to retire a generating unit because the cost to operate the unit is not economic relative to alternative energy sources available to the GRO, but for which MISO determines that the unit must be maintained to ensure network reliability. MISO requires the generating unit to remain in service and the GRO is compensated for keeping the unit in service. An SSR agreement formalizes the amount of compensation to be received by the GRO and establishes an appropriate allocation of the compensation to the load serving entities that benefit from the operation of the SSR unit. WPSC's share of such costs is dependent on upcoming Federal Energy Regulatory Commission decisions on complaints regarding the level and allocation of these costs.

Q. Why do you propose that major power plant outage expenses be reflected in a 2016 test-year limited reopener?

[2] $345 million times 10.95 percent economic cost of capital and 2.72 percent composite depreciation expense, for nine-twelfths of the year.

A. WPSC performed major planned power plant maintenance during 2015. However, in 2016, no similar major maintenance is planned. Preliminary information indicates that this will cause a decrease in revenue requirement of approximately $8 million from 2015 to 2016.

Q. Why do you propose that synergy savings be reflected in a 2016 test-year limited reopener?

A. Synergy savings should be reflected to ensure that ratepayers share in the financial benefits of the acquisition and to ensure that the acquisition is in the best interests of WPSC ratepayers. An amount consistent with Mr. O'Donnell's testimony would serve to offset part of the rate increase (or enlarge the rate decrease) associated with the other three items.

Q. Why do you propose that no other items be included in the limited reopener?

A. While there will doubtless be many items that would increase or decrease WPSC's 2016 revenue requirement as compared to the revenue requirement authorized by the Commission for the 2015 test year, I believe that such items may largely offset each other.

Q. Do you have any empirical evidence on which to base your assertion?

A. Yes. I have analyzed WPSC's authorized revenue requirement for the period of 2011-2015 by starting with the overall rate increase or decrease authorized by the Commission, and removing items related to monitored fuel. Monitored fuel related items include the increase or decrease in monitored fuel costs and any fuel refunds or surcharges included in the rate increase or decrease.

Q. What is the result of your analysis?

A. As shown in Ex.-PSC-Larson-1, if items related to monitored fuel are excluded, WPSC's rates would have been adjusted downward by an average of $4.4 million (0.4 percent) for electric operations, and downward by $3.2 million (0.9 percent) for natural gas operations. The decreases have been fairly consistent as well. Decreases have occurred for four out of the five years for electric, and four out of five years for natural gas.

Q. Why did you remove amounts related to monitored fuel from this analysis?

A. I removed amounts related to monitored fuel because Wis. Admin. Code ch. PSC 116 requires that monitored fuel costs be updated each year. WPSC will recover its 2016 monitored fuel costs based on those rules. The relevant question is what other costs to include or exclude from a reopener.

Q. Do you know of any items that are likely to materially increase or decrease WPSC's revenue requirement in 2016?

A. I know of the following items:[3]

- Decrease of $5.7 million due to savings associated with the Integrys Customer Experience project;[4]
- Increase of $6 million associated with another year's capital expenditures for the System Modernization Reliability Project.[5]

Since these items approximately cancel each other out, and are starting to get in the dollar range where there may be numerous items of similar magnitude whose inclusion in a reopener would defeat the purpose of limiting the scope of review for a reopener, I do not recommend including them in a reopener.

[3] While transmission costs may or may not be another item that increases substantially in 2016, the Commission has authorized escrow treatment for these costs.

[4] See tab A-2 of attachment to WPSC's response to data request 28-CWL-1 in docket 6690-UR-123, PSC REF#: 215592.

[5] This is a rough estimate based on $222 million of approved total project cost in docket 6690-CE-198, divided by five years, times 10.95 percent economic cost of capital and 2.72 percent composite depreciation rate.

Q. Are there other reasons that you recommend that a reopener for WPSC be limited to the items you suggest?

A. Yes. If too many items are included in the reopener, questions will likely arise as to how the acquisition might affect each of the items, and an accurate answer may not be known in time to be reflected in revenue requirement.

Q. If the Commission chooses to adopt bill credits, write-downs of regulatory assets, and reopener credits as a condition of the acquisition, what effect might this have on Wisconsin Energy Corporation's (WEC) commitments regarding employees?

A. I believe there will be little if any impact on WEC's commitments regarding employees for the following reasons:

- WEC's commitment applies to union employees only, not management.
- WEC's commitment excludes employee reductions due to attrition.

Q. Do you have any comments about potentially imposing a rate freeze on all or some of the services of the Wisconsin Operating Companies?

A. While the concept of a multi-year rate freeze has some appeal in keeping rates stable and avoiding the issue of whether to allow recovery of transition costs as discussed more fully by Mr. O'Donnell, there are downsides to this approach.

First of all, the revenue requirement may actually decrease during some or all of the years during the freeze period due to synergy savings exceeding the transition costs, or decreases in costs not related to the acquisition. In past mergers, the Commission has authorized rate freezes of four and five years. Since Commission staff does not have enough information to accurately project four or five years of revenue requirement for the Wisconsin Operating Companies, it would be difficult to predict if a rate freeze is in the best interest of the customers.

Secondly, the Commission's experience with rate freezes is that ratepayers bear more risk from rate freezes than appearances suggest. If utilities experience substantial and unanticipated cost increases during the freeze, they are likely to ask for such costs to either be reflected in a limited reopener or deferred until the end of the freeze period. Meanwhile, decreases in costs may escape scrutiny and not be reflected in rate decreases.

Q. What deferrals and rate increases did the Commission grant to Wisconsin Power & Light Company (WPL) during its 1997-2001 "rate freeze"?

A. The Commission's Order approving the merger of WPL Holdings and Interstate Power Co. and IES Industries[6] required that rates be frozen for four years. During the rate freeze, WP&L was granted approval for the following cost deferrals:

Table 2: WP&L Deferrals Granting During Rate Freeze Period

Docket	Order date	Description
5-CE-151	3/21/97	Kewaunee steam generation
6680-UR-110	4/29/97	D&D refund and gain on sale of South Fond du Lac
6680-UR-110	5/27/98	Y2K costs
5-ER-101	7/7/98	Kewaunee steam gen
5-CE-108	4/2/99	NOx
6680-EI-104	1/11/00	Rockgen
5-EI-121	2/25/00	ATC startup
5-EI-124	12/22/00	ATC startup
6680-EI-109	12/26/01	Security and insurance costs due to 9/11

In addition, WP&L was allowed to increase rates during the "freeze" period by $3.3 million in 1998, and $5 million in 1999.

Q. What deferrals and rate increases did the Commission grant to WEPCO during its 2000-2005 "rate restriction" period?

[6] Final Decision in docket 6680- UM-100, issued November 5, 1997.

A. A five-year rate freeze for WEPCO was authorized in Docket Nos. 9401-YO-100/9402-YO-101 dated March 15, 2000, when it acquired WICOR. During the rate restriction period, WEPCO was granted approval to defer the following costs:

Table 3: WEPCO Deferrals Granting During Rate Freeze Period

Docket	Order date	Description
5-EI-121	2/25/00	ATC startup
5-EI-124	12/22/00	ATC startup
6680-EI-109	12/26/01	Security and insurance costs due to 9/11
6630-GF-107	4/10/03	Port Washington precertification costs
6630-GF-108	5/22/03	Presque Isle
6630-GF-111	4/19/04	PTF precertification costs

In addition, WEPCO was allowed to increase rates during the rate restriction period by 2.5 and 3.35 percent in 2004, and 3.1 percent in 2005.

Q. What were WEPCO's earnings during the period of the rate freeze?

A. As shown in Exhibit-PSCW-Kettle-1, WEPCO's actual regulatory ROE varied between 11.92 and 13.13 percent per year for the 2001 to 2005 period. Over that same period, WEPCO earned approximately $44 million in excess of its authorized ROE, despite requesting and receiving approval to defer various costs on six separate occasions.

Q. If the Commission believes that a rate freeze is appropriate, do you have any general comments?

A. Due to the numerous deferrals and rate increases that have occurred during past rate freezes, I do not believe a rate freeze is appropriate. If the Commission were to go ahead with a rate freeze, however, I suggest that, for any new deferrals during the rate freeze period, recovery of such deferred amounts should only be allowed to the extent the utility is earning less than its authorized ROE. The actual earned ROE could be measured on a regulatory basis, which means that revenues and expenses that the Commission typically excludes from rate recovery would similarly be excluded from the ROE calculation. In this manner, the Wisconsin Operating Companies would not be able to increase spending on items such as incentive pay to adjust the level of earnings so that they can defer costs.

Q. You have discussed possible conditions to ensure that customers receive the benefit of some or all of the anticipated first year synergy savings. What about synergy savings in subsequent years?

A. I propose for the Commission's consideration that each of the Wisconsin Operating Companies be required to file a full rate case some time in 2016, for the 2017 test year. I believe that WEC should be able at that time have a reasonable estimate of both synergy savings as well as the costs to achieve such savings. Commission staff could then fully audit such estimates.

ACCOUNTING ISSUES

Q. What is push-down accounting?

A. Push-down accounting refers to "pushing down" the acquirer's accounting and reporting basis (which is recognized in conjunction with its accounting for a business combination) to the acquired entity's stand-alone financial statements. After WEPCO's acquisition of WICOR, push-down accounting became an issue that staff investigated in WG's next rate case, docket 5-UR-102. Since that time, WG has annually reported the purchase accounting amounts associated with push-down accounting and such amounts are manually removed as part of Commission staff's rate case review.

Q. What is the most recent accounting guidance regarding push-down accounting?

A. In November 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-17. This standard makes the application of push-down accounting optional. As a result of this new information, WEC has stated that it plans to keep the financial statements of the acquired regulated subsidiaries at historical cost.[7]

Q. Do you propose a condition regarding push-down accounting?

A. Yes. I believe that the Commission should require the following condition:

> Push-down accounting related to the Reorganization shall not be imposed upon or utilized by the Wisconsin Operating Companies for any purpose, including for financial and regulatory accounting, and ratemaking.

This will help ensure that the acquisition will not affect the capital structure of the Wisconsin Operating Companies as relevant to revenue requirements and ratemaking generally.

Q. Does that conclude your prefiled direct testimony?

A. Yes, it does.

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[7] WEC's response to data request PSCW-20.01, PSC REF#: 226506. See also WEC's response to data request PSCW-01.39, PSC REF#: 219110.